NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2007 through the Fourth Quarter of 2011

The current forecast comes with the warning that the economy's recent showing is not indicative of its future performance, especially in the short term. Rapid growth in the third quarter and a resilient labor market may suggest that the economy is doing just fine, but the storm clouds are still gathering. Growth is slowing, and the credit crisis remains, threatening a more severe tightening in credit to households and businesses. Under these conditions, growth is expected to stall in the fourth quarter, followed by weak but positive growth in the first quarter, before gradually improving over the rest of 2008. Key ingredients for this improvement are continuing robust export growth, lower oil prices, and a bottoming-out of housing starts by midyear.

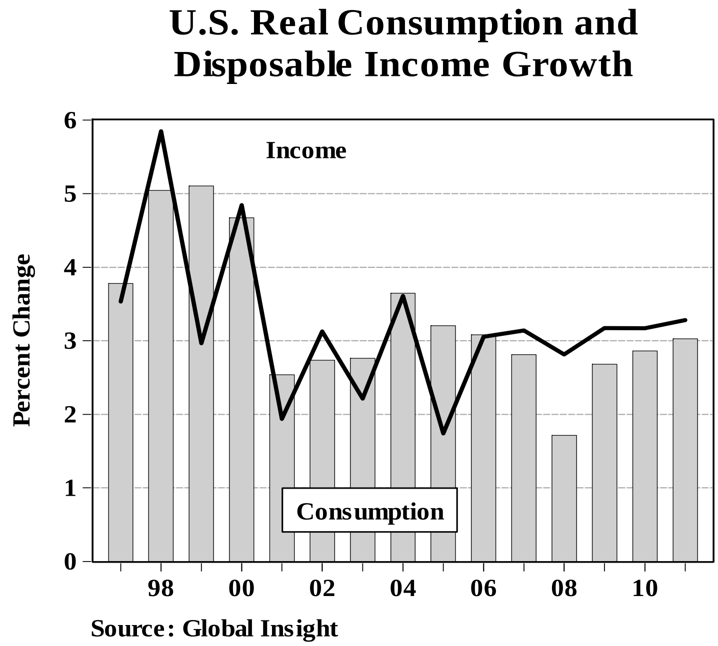
The economy is vulnerable to a potential double shock. The first shock is from housing and the credit crunch. Credit fears have re-emerged over the past month, while housing remains in a slump. Still threatening is a second shock from oil, although this risk has eased slightly over the past month, as prices have backed away from $100/barrel. It is assumed that prices will slide down to $75/barrel by the second quarter of 2008. Third-quarter GDP growth was impressive at 4.9%, revised up from 3.9%, but part of that revision came from stronger inventory accumulation—which is unlikely to be repeated. Growth dips to zero in the fourth quarter, as the decline in residential construction accelerates, consumer spending growth slows, and inventories become a drag, largely on production adjustments by automakers. Over the next three quarters, growth runs at an annual average pace of just 0.9%.

Housing remains the biggest drag on growth. The newly unveiled plan to freeze interest rates for some subprime borrowers, thereby limiting foreclosures, may reduce the downside risks to housing in 2008, but there is no magic solution to the overhang of unsold properties and no way to avoid further declines in home prices. Housing starts are forecast to hit bottom at just below 1.0 million units (annual rate) in the first half of 2008. Home prices will react more slowly than starts, but are heading lower too. The housing sector's blues will be shared by other parts of the economy.

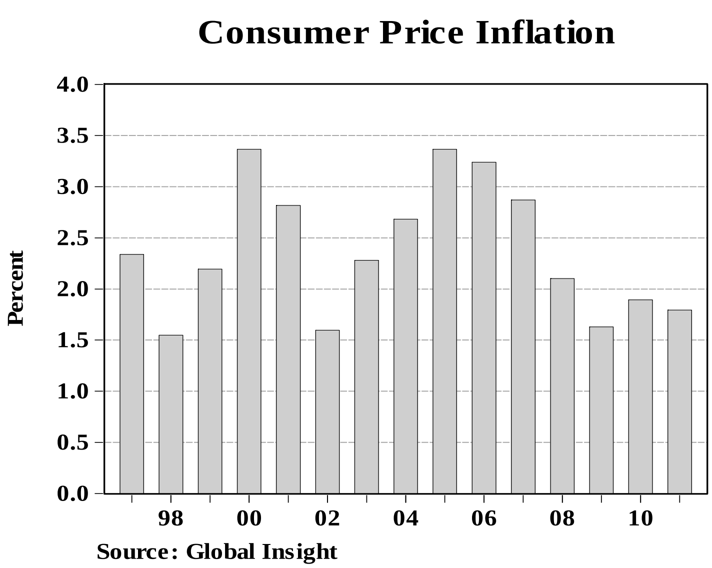
Slower employment gains, falling home prices, tighter credit availability, and high energy prices squeeze the consumer. As a result, spending growth is forecast to run at less than 1.5% annualized over the next three quarters. Indeed, 2007 is likely to be the first year since 2002 in which consumer spending growth falls short of income growth. Next year, consumer spending growth slips to 1.7%, well below the 2.8% gain in incomes. Slower growth in consumer and housing demand will make businesses more cautious about capital spending. Equipment spending growth is running around a 5.5% average pace in the second half of 2007, but should slow to just 2.2% in the first half of 2008. The incentive to spend will be greatest for businesses who are selling into export rather than domestic markets. Nonresidential construction has boosted GDP growth throughout 2007. But the decline in home-building and the recent sharp tightening in credit conditions will begin to weigh on commercial construction.

Fortunately, the falling dollar and relatively strong global economic growth should boost real net exports enough for the U.S. economy to skirt a recession. Falling prices should help gradually work off the huge housing inventory overhang, which will take an enormous weight off the economy's shoulders. Relieved of this burden, real GDP is expected to grow nearly 3.0% in each of the next three years.

SELECTED NATIONAL ECONOMIC INDICATORS



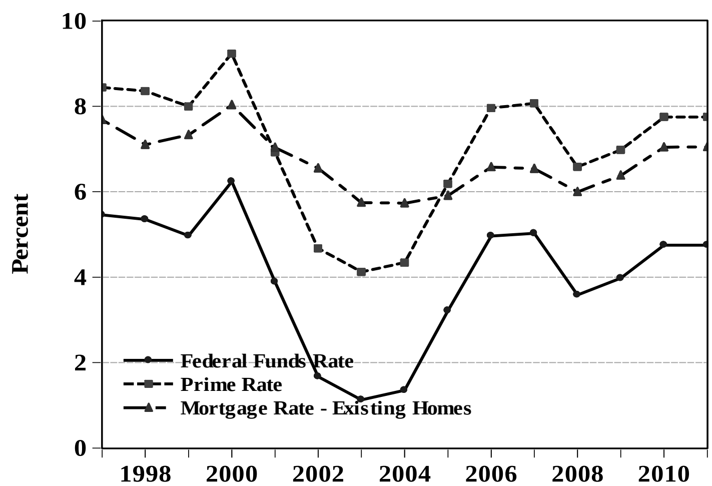
Consumer Spending: The nation's 16-year consumer spending spree is expected to continue despite threats in the form of the deepening housing slump, high energy prices, and a slowdown in job growth. After growing at a healthy 2.7% annual rate in the third quarter of 2007, real spending growth is expected to downshift, falling to a nadir of 0.8% in the first quarter of 2008. The housing situation's impact on spending deserves further clarification. Falling home prices are expected to erode household net worth and cause consumers to cut back on discretionary purchases. After declining 0.5% in 2007, real net worth is anticipated to eke out just 0.3% growth in 2008 followed by 1.1% growth in 2009. In addition, purchases of certain goods and services closely tied with the housing sector, such as appliances, furniture, and landscaping services, will also cool. Fortunately, total spending should be kept afloat by continued spending on electronics, health care, and recreation. It needs to be pointed out that high oil prices pose a significant risk to the consumer spending outlook. In November 2007 it was assumed a gradual retreat in the West Texas Intermediate crude oil price, from an average of $90 per barrel in the current quarter to $75 per barrel in the spring of 2008. It was calculated if oil prices were $10/barrel higher in 2008, real disposable income would be reduced by 0.4% and real consumption would be 0.3% lower. It was also determined the economy would have 100,000 fewer jobs and 190,000 fewer light vehicles would be sold. Over the forecast period, real consumer spending should grow more in line with income than it has in the past. Real spending is forecast to increase 2.8% in 2007, 1.7% in 2008, 2.7% in 2009, 2.9% in 2010, and 3.0% in 2011. Real disposable income is expected to expand 3.1% in 2007, 2.8% in 2008, and around 3.2% in each of the remaining years of the forecast.



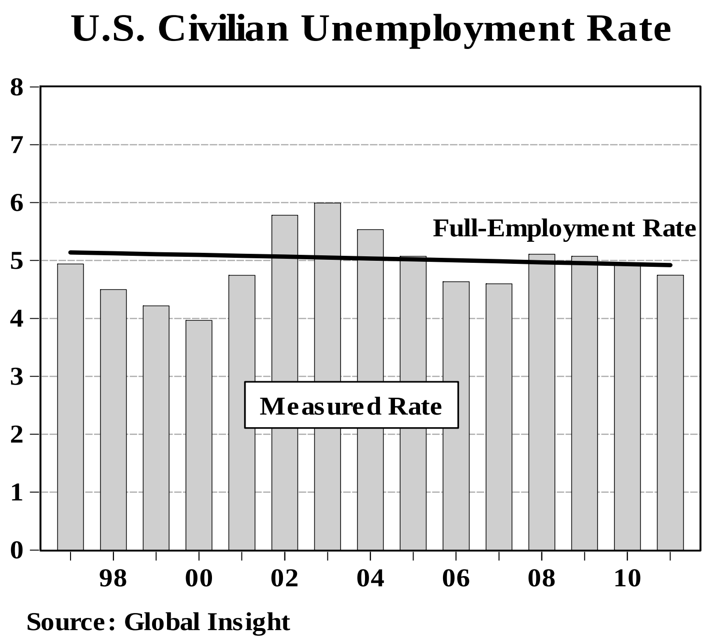
Inflation: Headline inflation should moderate over the forecast period, despite a flare up in late 2007. Inflation, as measured by the consumer price index, surged 4.5% in the fourth quarter due to pressures from its energy and food components. Food prices rose at a nearly 5.0% annual pace in that quarter and energy prices jumped at a 21.6% clip. However, when the impacts of these prices are removed from the index, core inflation rose just 2.3%. This moderate increase is good news. First, the impacts of rising energy and food prices remain well contained. While the prices of some consumer goods, such as airline tickets, have risen with fuel costs, the impacts have been surprisingly benign. One of the reasons for this is global competition makes it harder for domestic businesses to pass rising costs on to their customers. Second, employer costs increases have been relatively low. For example, they have risen at about a 3% pace in recent quarters. This is important because these costs are a major determinant of core inflation. Employer labor costs, and, therefore, core consumer inflation, are expected to remain modest because of the slackening job market. Specifically, employment costs are forecast to increase 3.1% in 2007, 3.0% in 2008, 2.8% in 2009, 3.0% in 2010, and 3.2% in 2011. Core inflation should increase 2.3% in 2007, 2.1% in 2008, 1.9% in 2009, 2.0% in 2010, and 2.0% in 2011. The current forecast assumes energy prices will retreat then remain relatively stable over the next few years. Thus, overall inflation is expected to recede over most of the next few years. Overall consumer price inflation is projected to run 2.9% in 2007, 2.1% this year, 1.6% next year, 1.9% in 2010, and 1.8% in 2011.

Financial Markets: The recent aggressive policy action by the nation's central bank seems to be having some positive impact on the credit crises and the stability of the financial markets. As of early December, the Federal Reserve had lowered its federal funds rate a cumulative 75-basis points since September 18, 2007. This reduction resulted in lowered borrowing costs. For example, fixed-rate mortgages dropped about 50 basis points to near 6.2% in early November. While the effective reduction of borrowing costs is a positive development, in several other critical dimensions the recent distress in the financial and credit markets actually turned south. First, the major debt-rating agencies continued to downgrade the ratings of mortgage-backed securities. The lower ratings continues to put severe downward pressure on mortgage-backed securities prices, which is putting more bank capital at risk beyond the write-downs that have already been taken. Second, the volume of asset-backed commercial paper outstanding declined through early November. Third, credit conditions have tightened. A Federal Reserve survey of senior loan officers in October showed tighter credit conditions for mortgages rose to a historical high this fall. Unfortunately, not only did credit conditions tighten for mortgages, but they also tightened significantly for commercial loans, commercial real estate loans, and other consumer loans. Not surprisingly, consumer credit growth has slowed. Until recently, consumers had been tapping credit card and auto loans to offset tighter credit conditions on home equity loans and refinancings. It now appears even these borrowing sources are drying up. Given the softening economic conditions, the question this fall was not if the Federal Reserve would loosen, but when and by how much. The answer came on December 11, 2007 when the Central Bank lowered its federal funds rate by 25 basis points. This move was anticipated and is built in to this forecast. This forecast also assumes the Federal Reserve will lower its federal funds rate by another 75 basis points to 3.5% over the first quarter of this year, and it will remain there through the rest of 2008. Once the Federal Reserve is convinced the economy has negotiated this rough patch, it will begin to tap on the monetary brakes, with the federal funds rate climbing to 4.8% by the end of 2010.

Selected U.S. Interest Rates

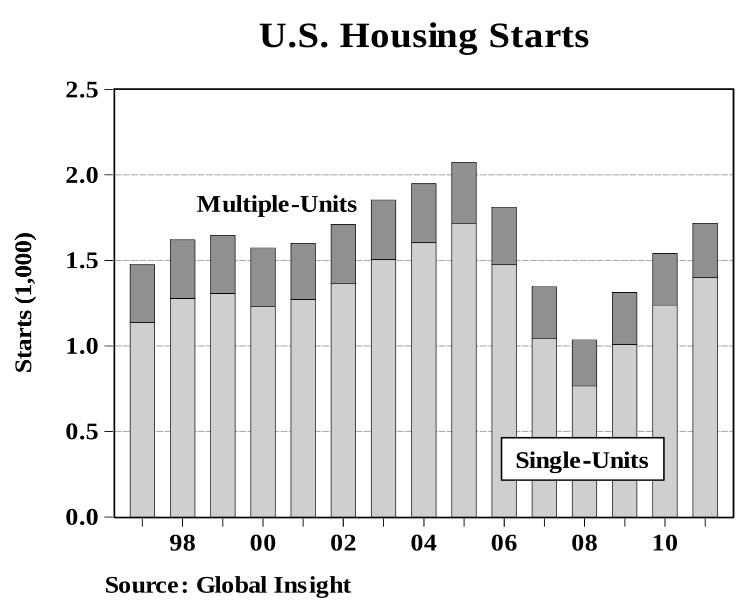


Source: Global Insight



Employment: While labor markets are expected to cool over the next few quarters, they should remain warm enough to help keep the economy afloat. Many economists were pleasantly surprised when the U.S. Department of Labor reported nonfarm payroll employment increased by 94,000 jobs in November 2007 and the unemployment rate held steady at 4.7%. The report pointed out job growth continued in the professional and technical services, health care, and food services sectors. On the other hand, manufacturing continued to shed jobs, as did several other housing-related sectors, including construction, credit intermediation, and real estate. Overall, nonfarm employment is forecast to have increased 1.0% in the last quarter of 2007. Unfortunately, this will be the high-water mark for several quarters. Nonfarm employment growth is forecast to slip below one percent in each of the first three quarters of this year. This slower job growth will further loosen labor markets, sending the unemployment rate to 5.2% by this year's third quarter. The hiring rate rises back above 1.0% beginning in the fourth quarter of 2008, once companies are convinced the economy is again on solid footing. Unfortunately, nonfarm employment does not improve fast enough to make a significant dent in the unemployment rate until later in the forecast horizon. After peaking at 5.2% in this year's third quarter, the civilian unemployment rate is still around 5.0% in 2010. It drops to 4.7% in 2011. It should be pointed out that the unemployment rate is higher than what is considered full-employment over most of the next few years.

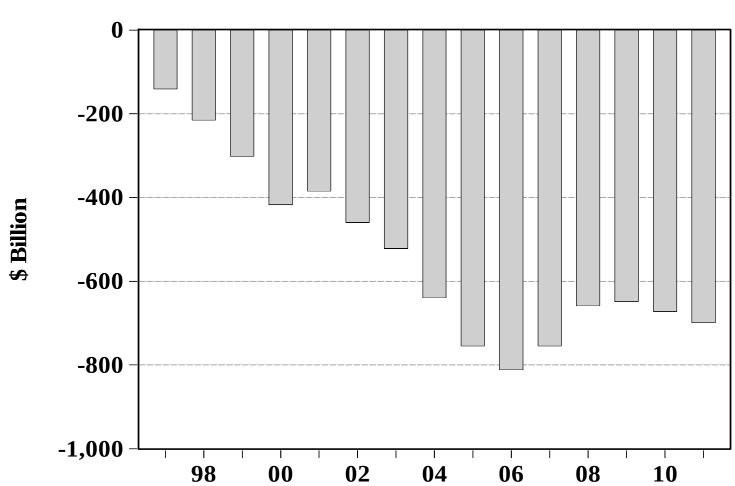
Housing: Housing remains the biggest drag on the U.S. economy. Residential investment reduced economic output growth by 0.3 percentage point in 2006 and an estimated one percentage point in 2007. The housing industry is already two years into its recession, and it has yet to find its trough. Existing home sales plunged 4.7% in August and another 8.0% in September—to its lowest level since this data has been published. Other data also expose this sector's recent weaknesses. Housing starts sank 10.2% in September to their lowest level since March 1993. Single-family permits fell 7.1% that same month, portending another drop in housing starts in the fourth quarter of 2007. The inventory outlook also worsened this fall. The supply of existing single-family homes rose from 9.3 months to 10.2 months—its highest reading since February 1988. This inventory glut has pushed down housing



prices. For example, the Office of Federal Housing Enterprise Oversight reported at the end of November its quarterly Housing Price Index (HPI) shrank for the first time in nearly 13 years in the third quarter of 2007. Unfortunately, housing prices are expected to slide further. The newly unveiled plan to freeze interest rates for some subprime borrowers may reduce the downside risks to the housing sector in 2008, but it is not a silver bullet solution to the inventory over hang and falling prices. The HPI is forecast to fall another 6.3% this year and 3.8% next year. While unpleasant, these declines are necessary for this industry's eventual recovery. Lower housing prices should eventually stimulate new and existing homes sales in the second half of 2008. The rebound in sales will help work off bloated inventories and set the stage for a rebound in single-family housing starts. Housing prices are expected to rise again in 2010. In summary, US housing starts are forecast to fall to 1.035 million units in 2008, but increase to 1.312 million units in 2009, 1.540 million units in 2010, and 1.717 million units in 2011.

International: International trade should be an important counterweight to the faltering housing sector. Unlike construction, real exports are expected to be a positive contributor to real GDP growth over the next few years. Specifically, net exports add 0.6 percentage point to real output in 2007, 0.9 percentage point in 2008, and 0.3 percentage point in 2009. This change marks a significant reversal. Up until last year, real exports were a drag on economic growth. The expected turnaround in real exports is being fueled by robust global growth and the weakening dollar. Growth in Asia is most promising. The mild global slowdown will only put a small dent in China's rapid growth rate. However, the Chinese government may have to tighten conditions later this year in order to prevent its economy from over heating. Of course, this policy runs the risk of overshooting the target, which could make for a harder-than-expected landing. This is important because the fates of several other Asian economies are tied to China's economy. Another Asian powerhouse is India. Thanks to domestic-led growth, this country should be able to sustain around 8.5% growth over the next few years. Not all the world's economies will grow this fast, however. Except for commodity-exporting countries, world economic growth is expected to "recouple" with the United States and slow down. Europe will be hit by multiple headwinds, including the global slowdown, a stronger currency, the continuing credit crunch, high oil prices, and housing problems in some countries. Japan will be similarly afflicted, although there is little evidence of fallout from the subprime and housing-related problems of the United States. For Canada and Mexico, weak U.S. growth will be offset by strong oil prices. Real exports will also benefit from the falling dollar that tips the scale in favor of U.S. goods and services in the global market. The greenback has lost about one-fifth of its value over the last five years, and its slide is not over. Sentiments on the dollar should begin to improve in the second half of this year and early 2009, as the economy recovers. The Canadian dollar may have already peaked against the greenback, if oil prices keep falling. This forecast assumes the euro peaks at around $1.55 next summer and falls to $1.49 by year end. However, both the Japanese yen and Chinese renminbi should continue to rise against the dollar because of the large current-account surpluses in both countries.

U.S. Current Trade Deficit



Source: Global Insight

Government: The current forecast assumes Congress will not allow all of the Bush tax cuts to expire as scheduled at the end of 2010. The income tax burden is expected to increase, however, through the capricious impact of the Alternative Minimum Tax or through some kind of tax reform that raises revenues. However, no major tax initiatives are anticipated before the 2008 presidential election. The unified federal budget deficit shrank to $162.8 billion in 2007—its third straight annual decline. Unfortunately, the streak of declining deficits is expected to end soon. Predicted faster federal spending growth and slower revenue growth point to growing deficits in the future. The unified federal budget deficit swells to $304.5 in 2008, to $342.8 billion in 2009 and $348.3 billion in 2010 and then shrinks to $307.1 billion in 2011.